Attachment 2

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February 23, 2011

Dr. George Diehr
Chair of the Investment Committee
California Public Employees' Retirement System
400 Q Street
Sacramento, CA 95814

Re: CERBT Asset Allocation

Dear Dr. Diehr:

You requested Wilshire's opinion with respect to Staff's asset allocation recommendation for the CERBT (California Employers' Retirement Benefit Trust).

Overview and Recommendation

Wilshire recommends that the Investment Committee approve the proposed asset allocations, subject to our comments below with respect to TIPS. Employers will now be given a choice of three allocations, ranging in expected risk and return from conservative to moderate to aggressive. We do note that in many cases the constraints that Staff has used in the asset allocation process are binding and the Investment Committee may wish to discuss the constraints with Staff.

We recommend that these target asset allocations be revisited in 2-3 years as the CERBT continues to grow and as Staff gathers feedback from Employers. We also recommend that Staff consider how often employers will be permitted to change their chosen allocation. While this is unlikely to have a significant impact during most market environments, it is conceivable that employers would be reactionary during difficult market environments, perhaps to their detriment.

Discussion

The asset allocation analysis that Staff has conducted for the CERBT is an asset-only study, focused on identifying portfolios that maximize expected return for a given level of return variability. This differs from the PERF ALM workshop which incorporated characteristics of the liabilities into the analysis and resulting metrics of potential success. There are significant differences in the nature of the benefits "owed" in the future as the CERBT represents prefunding of OPEB benefits. Each employer makes their own assessment about the future payments; how much to prefund, if any; and how conservatively or aggressively to invest. In this case, we believe that an asset-only study is appropriate for the CERBT.

Staff has largely aligned the public asset classes used in the PERF for consideration in this analysis: global equity, fixed income (ex-TIPS), TIPS, global REITs, and commodities. High yield bonds, which have been a separate allocation within the CERBT, are now folded into the broad fixed income category. In addition, Staff has included constraints on the asset classes that reflect their beliefs about the investability of each and the appropriateness of each for the CERBT portfolios.

As you will note, all of the portfolios face binding constraints with respect to two or three asset classes: 1) global REITs (maximum of 8%), 2) commodities (maximum of 3%), and TIPS (minimum of 5% and maximum of 15%). While we believe that the constraints on commodities and global REITs seem reasonable, we have discussed the TIPS constraint with Staff. We recognize that for global REITs and commodities, much of the value they bring to the proposed portfolios is diversification (i.e., lower correlation, particularly to stocks). TIPS also provide the same diversification benefits, but provide liquidity, safety, and inflation protection. Therefore, we view the maximum constraints on commodities and global REITs as appropriate for "risky" assets (as measured by standard deviation of returns) but believe that the upper limit on TIPS may be something that the Investment Committee should evaluate.

In optimizations without the TIPS upper limit, Staff noted that the TIPS allocation became 28% of portfolio P2 (the most conservative portfolio that Staff is recommending) but portfolios P5 and P8 are largely or totally unaffected. If the Investment Committee believes that employers who favor the most conservative of the CERBT portfolios will not be put off by a higher allocation to TIPS and the role of TIPS in the portfolio, we recommend you direct Staff to allow a higher allocation to TIPS for portfolio P2.

Finally, we recommend that Staff reevaluate the asset allocations for the CERBT portfolios in no less than three years (which would largely be coincident with the next ALM workshop for the PERF). Given the rapid growth of the CERBT and the change from a single option to three risk-based options, we believe that it is prudent to regularly review the allocations. As time passes, Staff should be able to discern additional preferences from the CERBT investors that may sway future asset allocations. We also encourage Staff to monitor the behavior of the CERBT investors. In the event that investor behavior becomes challenging, limitations on transactions may need to be imposed.

Conclusion

As noted, Wilshire supports the CERBT asset allocation recommendations, with the caveat that, like all asset allocation studies, sound judgment must be applied as the basis for the allocation study are estimated returns, risks and correlations, which are imprecise.

Should you require anything further or have any questions, please do not hesitate to contact us.

Best regards,